

**DEPARTMENT OF STATE REVENUE****LETTER OF FINDINGS NUMBER: 02-0518****Income Tax****For Tax Years 1996-98**

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**ISSUE****I. Adjusted Gross Income Tax—Apportionment Method**

**Authority:** IC 6-8.1-5-1; 45 IAC 3.1-1-8; 45 IAC 3.1-1-50; 45 IAC 3.1-1-51; 45 IAC 3.1-1-52; 45 IAC 3.1-1-55

Taxpayer protests the method used to determine Indiana apportioned income.

**II. Tax Administration—Negligence Penalty**

**Authority:** IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent negligence penalty and interest.

**STATEMENT OF FACTS**

Taxpayer operates in several states, including Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for income tax for the tax years 1996-98. Taxpayer protested some of the proposed assessments and paid some of the proposed assessments. Taxpayer paid all of the assessments except an amount equal to the penalty for 1996 and 1997. Taxpayer protested the penalties for 1996 and 1997. Taxpayer protested the entire assessment for 1998. Further facts will be supplied as required.

**I. Adjusted Gross Income Tax—Apportionment Method****DISCUSSION**

Taxpayer protests the Department's apportionment method for adjusted gross income. The Department apportioned income since taxpayer had operations in Indiana and other states. The relevant regulations for determining the sales factor for apportionment are 45 IAC 3.1-1-50, 45 IAC 3.1-1-51 and 45 IAC 3.1-1-52. 45 IAC 3.1-1-50 states:

“Sales” means all gross receipts of the taxpayer which are not subject to allocation as nonbusiness income. The following are examples of sales in various situations:

- (1) If the taxpayer’s business activity consists of manufacturing and selling or purchasing and reselling goods or products, “sales” includes all gross receipts from the sales of such goods or products (or other property which would be included as inventory of the taxpayer if on hand at the close of the tax year) held by the taxpayer primarily for sale in the ordinary course of business. Gross receipts for this purpose means gross sales price, less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) shall be included as part of such receipts and shall be in the sales factor only if such taxes are included in the gross receipts or gross sales as reported on the taxpayer’s Federal returns.
- (2) If the taxpayer’s business activity consists of providing services, such as the operation of an advertising agency, or the performance of equipment service contracts or research and development contracts, “sales” includes the gross receipts from the performance of such services including fees, commissions and similar items.
- (3) If the taxpayer is working under a cost plus fixed fee contract, such as the operation of a government owned plant for a fee, gross receipts includes the entire reimbursed cost plus the fee.
- (4) If the taxpayer is in the business of renting real or tangible personal property, “sales” includes the gross receipts from the rental, lease, or licensing the use of the property.
- (5) If the taxpayer is in the business of selling, assigning, or licensing of intangible personal property such as patents and copyrights, “sales” includes the gross receipts therefrom. In some cases, certain gross receipts should be disregarded in determining the sales factor to effectuate an equitable apportionment.

#### 45 IAC 3.1-1-51 states:

The denominator of the sales factor includes all gross receipts from the taxpayer’s sales, except as noted in Regulation 6-3-2-2(l)(010) [45 IAC 3.1-1-62]. The denominator shall not include sales made between members of an affiliated group filing consolidated returns under IC 6-3-4-14.

#### 45 IAC 3.1-1-52 states:

The numerator of the sales factor generally includes gross receipts from sales attributable to this state, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales regardless of the place where the accounting records are maintained or the location of the contract or other evidence of indebtedness. The numerator shall not include sales between members of an affiliated group filing consolidated returns under IC 6-3-4-14.

Taxpayer protests that 45 IAC 3.1-1-55 should result in a zero apportionment numerator, which in turn would result in a zero sales factor. That regulation states in relevant part:

Gross receipts from transactions other than sales of tangible personal property shall be included in the numerator of the sales factor if the income-producing activity which gave rise to the receipts is performed wholly within this state. Except as provided below if the income producing activity is performed within and without this state such receipts are attributed to this state if the greater proportion of the income producing activity is performed here, based on costs of performance. The term “income producing activity” means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. Such activity does not include activities performed on behalf of the taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, “income producing activity” includes but is not limited to the following: (1) The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service. (2) The sale, rental, leasing, or licensing the use of or other use of tangible personal property. (3) The sale, licensing the use of or other use of intangible personal property.

Income producing activity is deemed performed at the situs of real, tangible and intangible personal property or the place where personal services are rendered. The situs of real and tangible personal property is at its physical location. The situs of intangible personal property is the commercial domicile of the taxpayer (i.e., the principal place from which trade or business of the taxpayer is directed or managed), unless the property has acquired a "business situs" elsewhere. "Business situs" is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property.

Example: Taxpayer, a corporation whose principal business activity is the manufacture and sale of hot water heaters, obtains notes for the sale of such water heaters in connection with its Indiana business activity. The property has a business situs in this state, therefore, interest income derived from such notes is attributable to this state.

The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.

If receipts from sales other than sales of tangible personal property do not constitute a principal source of business income and such receipts are included in the denominator of the receipts factor, such receipts are in this state if: (a) the income producing activity is performed wholly within this state; or (b) the income producing activity is performed both in and outside this state and a greater proportion of the income producing activity is performed in this state than in any other state, based on costs of performance.

Taxpayer believes that, according to 45 IAC 3.1-1-55, the income should not be attributed to Indiana based on the costs of performance. Taxpayer believes that the income should be attributed to other states based on the costs of performance.

Taxpayer has not provided any documentation to support this claim. There is no evidence in the protest file to indicate where costs of performance are incurred. Under IC 6-8.1-5-1(b), the burden of proving an assessment wrong rests with the taxpayer. In this case, taxpayer has not met that burden.

Taxpayer also expressed confusion as to what amount of income tax the Department assessed for 1998. The audit report listed one amount and the notice of tax due listed an amount approximately eleven thousand dollars higher. After reviewing the Department's records, the lower amount listed on the audit report is the correct amount of income tax due for 1998.

Taxpayer also protested that the Department incorrectly listed an extra two million, seven hundred forty four thousand, three hundred and seven dollars (\$2,744,307.00) in net income adjustment for 1998. The Department referred to 45 IAC 3.1-1-8 in explaining this adjustment. After reviewing supplemental materials, another auditor for the Department agreed that the \$2,744,307.00 should not have been added to taxpayer's income.

In conclusion, taxpayer paid the base amounts of tax for 1996 and 1997. For 1998, taxpayer has not met the burden of proving that it is entitled to the provisions of 45 IAC 3.1-1-55, as required by IC 6-8.1-5-1(b). Taxpayer is correct that the \$2,744,307.00 should not be included in its income calculations. The original liability amount listed on the audit report was correct.

### **FINDING**

Taxpayer's protest is denied regarding apportionment method.

## **II. Tax Administration—Negligence Penalty**

### **DISCUSSION**

Taxpayer protests the imposition of penalty. The Department refers to IC 6-8.1-10-2.1(a), which states in relevant part:

If a person:

...

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

...

the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC 6-8.1-10-2.1(a). Taxpayer has, as part of this protest, established that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

### **FINDING**

Taxpayer's protest is sustained.